Editor's Note: Reconsideration granted; decision modified by Amoco Production Co., 148 IBLA 255 (1999)

AMOCO PRODUCTION CO.

IBLA 95-301, 95-305 Decided March 24, 1998

Appeal from Decisions of the Associate Director for Policy and Management Improvement, Minerals Management Service, affirming Orders requiring a restructured accounting of the value of gas sold to an affiliate and the value of scrubber condensate and flash gas. MMS 91-0150-OCS, MMS 91-0149-OCS.

Affirmed in part, vacated and remanded in part.

1. Oil and Gas Leases: Royalties: Generally--Federal Oil and Gas Royalty Management Act of 1982: Royalties

In valuing residue gas or gas plant products sold in a non-arm's-length transaction for royalty purposes, reference is properly made to comparable arm's-length sales from the same plant. Marketing costs are the obligation of the lessee and, when it appears that the sale price reflects the deduction of marketing costs, a decision requiring the lessee to recalculate royalties on the basis of a value which includes the marketing costs will be affirmed on appeal.

APPEARANCES: Jonathan A. Hunter, Esq., New Orleans, Louisiana, for Appellant; Sarah L. Inderbitzin, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

These appeals have been brought by Amoco Production Company from two separate Decisions of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), dated January 9, 1995. The appeal of the Decision in MMS-91-0150-OCS, docketed by the Board as IBLA 95-301, challenged the asserted improper valuation of gas produced from Federal oil and gas lease OCS-G 5000 and sold to Amoco's affiliate, Amoco Gas Company (AGC), from June 1986 through February 1991. This appeal also disputed the asserted error in calculation of royalties on scrubber condensate and the alleged failure to pay royalties on flash gas. The appeal of the Decision in MMS-91-0149-OCS, docketed by the Board as IBLA 95-305, contested the asserted underpayments of royalty on scrubber condensate and flash gas on a different lease. In view of the similarity of the issues raised by these appeals, they were consolidated for purposes of review by Order dated June 17, 1996.

Subsequent to receipt of Appellant's Statement of Reasons (SOR) for appeal in these cases, counsel for MMS has filed a Motion to Remand and Answer. The Motion to Remand was grounded on a finding on the basis of additional information provided with Appellant's SOR that Appellant has now demonstrated that it does not owe additional royalty on either scrubber condensate or flash gas. In consideration of the Motion, we deem it appropriate to vacate the Decisions appealed from to the extent that they held Appellant liable for additional royalty on scrubber condensate and flash gas and remand the cases to MMS on these issues. Hence, the remaining question before us concerns valuation of gas sold by Appellant to AGC.

This case commenced with an Order dated April 9, 1991, from the Dallas Area Compliance Office, MMS, to Amoco regarding payment of royalties on production from oil and gas lease OCS-G 5000 from June 1986 through February 1991. It indicated that MMS had conducted a review of royalty paid and that its audit had disclosed underpayments for certain sample months during the audit period. The Order stated:

> Our review determined that for the test months of June and October 1986, March 1987 and March 1989, Amoco valued gas sold under a Short Term Industrial Market Program (STIMP) pursuant to a non-arm's-length contract between Amoco and AGC. The royalty values were computed based on 90 percent of the monthly weighted average resale price received by AGC for Amoco's share of the gas sold under the STIMP, less the cost of transportation. The weighted average STIMP price means a price per MMBtu equal to the sum of all STIMP sales contract monies payable to AGC for all gas sold each month divided by the total MMBtu's sold by AGC in each month.

(Order of April 9, 1991, at 1.) In order to bring royalty payments into compliance with the applicable regulations, Amoco was directed by the Order to recalculate royalties due under the lease from initial production in June 1986 through February 1991 to "include 100 percent of the gas value accruing to AGC." Id. at 4.

Concerns about the valuation for royalty purposes of gas produced from the lease sold by Appellant to AGC were earlier disclosed in a September 27, 1988, memorandum from the Dallas Area Compliance Office, MMS, to the Chief, Royalty Valuation and Standards Division, MMS. This memorandum indicated that the contract price was not an acceptable valuation for royalty purposes because, under the regulations, no deduction from gross proceeds is allowed for marketing costs and the deduction from the AGC price was considered to be a marketing fee. Finding that the gross proceeds to the lessee had been reduced "by costs or fees for services performed by others which the lessee would otherwise be required to perform at no cost to the Federal lessor, i.e., marketing costs," the memorandum indicated that "the gross proceeds accruing to the lessee must be increased, for royalty purposes, by an amount equal to such costs to arrive at the value." (September 27, 1988, memorandum at 4.)

In a December 7, 1990, letter responding to an MMS issue letter relating this concern, Amoco challenged the assertion that valuation should be based on 100 percent of the AGC resale price. Appellant cited Amoco Production Co., 112 IBLA 77 (1989). Amoco asserted that in that case the Board indicated that, under the Procedure Paper on Natural Gas Liquid Products Valuation, MMS will normally accept a non-arm's-length contract price for royalty purposes when the lessee can show that the contract has characteristics similar to arm's-length contracts which represent fair market value. Appellant further noted we recognized that the fact that third- party contracts include deductions for marketing costs does not establish that the price is not fair market value.

Appellant contends in its SOR for appeal that the MMS Decision fails to consider the relevant regulation regarding valuation of gas sold pursuant to a non-arm's-length contract. Appellant asserts that, under the regulatory revision promulgated in 1988, the regulation governing valuation of processed gas not sold under an arm's-length contract is relevant to valuation of the gas sold to AGC. 30 C.F.R. § 206.153(c). Under that regulation, the value of residue gas or any gas plant product not sold pursuant to an arm's-length contract amounts to the gross proceeds accruing to the lessee, provided that the gross proceeds are equivalent to the gross proceeds derived from comparable arm's-length contracts of like-quality residue gas or gas plant products from the same plant. Further, Appellant argues that although the pre-1988 regulations did not specifically address valuation of production not disposed of at arm's length, the 1988 regulation is properly applied retroactively in the absence of any intervening rights of third parties or prejudice to the public interest.

Appellant notes that the MMS Order makes no reference to prices received under comparable arm's-length contracts and asserts that MMS is unable to establish that the valuation used is less than any such prices. Amoco contends that the prices given by MMS in response to its inquiry regarding prices for gas processed and sold at the Matagorda Plant show that its prices are comparable for 3 of the 4 sample months and only 4 percent lower for the month of June 1986. Appellant argues that the MMS Decision errs in its focus on the manner in which the value under the affiliated transaction is determined as opposed to comparing the value to arm's-length prices. Appellant contends that MMS has failed to present any evidence of values under arm's-length sales to support its Decision. 1/

1/ Appellant also refers to defenses raised on appeal to the Director including the assertion that the MMS Order unlawfully requires Amoco to (1) perform a self audit and (2) generate records not previously maintained. Conceding that this Board has rejected these defenses in prior cases, Appellant expresses the desire to preserve the argument in the

In its Answer to the SOR filed by Appellant, MMS contends that Amoco had a duty to market its production at no cost to the lessor and that a lessee cannot reduce the price by paying a third party to market the gas, citing 30 C.F.R. § 206.157 (1987). The duty of the lessee under the 1988 regulatory revisions to place gas produced from leases in marketable condition at no cost to the lessor is also noted by MMS, citing the valuation regulations. 30 C.F.R. § 206.153(i). It is pointed out by MMS that this requirement also existed prior to the 1988 regulatory revisions. 30 C.F.R. § 250.42 (1986). Noting that Appellant's price for sale of the gas to AGC was 90 percent of the resale price received by AGC, MMS argues that it properly concluded that the deduction was for marketing expenses payable by the lessee and, thus, not allowable as a deduction.

[1] We recognize, as Appellant notes, that the value of residue gas or any gas plant product which is not sold at arm's length is generally determined by reference to the proceeds accruing to the lessee when those are equivalent to the gross proceeds paid under comparable arm's-length contracts for like quality residue gas or gas plant products from the same plant. 30 C.F.R. § 206.153(c)(1). The issue raised by this appeal, however, is not solely the proper regulatory standard for computing royalties, i.e., a comparable arm's-length sale of gas or gas plant products, but rather whether a deduction may be allowed for costs incurred to market the production. This same regulation also provides:

> The lessee is required to place residue gas and gas plant products in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement. Where the value established under this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of

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fn. 1 (continued)
event judicial review is pursued. In rejecting these arguments, we find it sufficient to note that the Secretary is required by § 101(c)(1) of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1711(c)(1) (1994), to "audit and reconcile to the extent practicable, all current and past lease accounts for leases of oil or gas." See 30 C.F.R. § 217.50. This Board has held that FOGRMA does not preclude the Secretary from directing a royalty payor to review royalty accounts in order to uncover underpayments traceable to identified defects in the payor's original calculation of royalties due. We have also approved the MMS practice of sampling certain leases, or certain production months for certain leases, leaving the payor the burden of uncovering all other instances of systemic deficiency. Texaco, Inc., 138 IBLA 202, 204-05 (1997); Texaco Exploration & Production, Inc., 134 IBLA 267, 269-70 (1995). Further, we note that at least one court has rejected an operator's argument that such MMS practices improperly required the operator to undertake a "self audit" in contravention of FOGRMA. Phillips Petroleum Co. v. Lujan, 963 F.2d 1380, 1386 (10th Cir. 1992).

> which ordinarily is the responsibility of the lessee to place the residue gas or gas plant products in marketable condition.

30 U.S.C. § 206.153(i) (1994). 2/ The question of the relationship between a comparable arm's-length sale price and the deduction of marketing expenses has been analyzed by this Board previously in the very case cited by Appellant below before MMS. Amoco Production Co., supra. In that case, we recognized that the fact that third-party contracts include a deduction for marketing costs does not disqualify them as arm's-length contracts or establish that the price is not fair market value. 112 IBLA at 83. We also held, however, that when the "price reflects deductions that may not be made in determining value for Federal royalty purposes, such deductions may be added to the contract price to derive the value of production for royalty computation." Id. The April 1991 MMS Order disclosed that the 10-percent deduction is distinct from the deduction of allowable transportation expenses associated with the gas. Accordingly, we find that Appellant has failed to show error in the MMS Decision requiring recalculation of royalty on gas sold to AGC to include marketing expenses improperly excluded.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is vacated and remanded in part and affirmed in part.

C. Randall Grant, Jr.
Administrative Judge

I concur:

David L. Hughes
Administrative Judge

2/ This regulatory requirement was also found in the regulations in effect prior to the 1988 regulatory revision. See 30 C.F.R. § 250.42 (1986).